ELECTRONICALLY REPRINTED FROM NOVEMBER 2014

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

COMMITTEE REPORT: INTERNATIONAL PRACTICE

By **Cynthia Brittain** & **Suzanne Shier**

Crossing Borders: Planning for Wealth in Motion

Know the different tax rules for U.S. and foreign persons to avoid unnecessary taxation

The wealth management world is increasingly international, particularly with the great mobility of wealth owners and the diminishing barriers of borders. The trends in students coming from abroad, family immigration and foreign investment in the United States present a multitude of wealth planning opportunities, as well as some potential pitfalls.

Who's Coming?

Consider these statistics:

- In the academic year that ended May 2012, an estimated 820,000 foreign students studied in the United States, up more than 7 percent from the previous year, the seventh consecutive year of increase and the steepest rise in four years. International students add approximately $24 billion to the U.S. economy annually.[1]
- Between 468,000 and 482,000 immigrant visas have been issued every year since 2009. Not surprisingly, immigrant visas are issued primarily for family sponsored preferences and immediate relatives, with the parent of a U.S. citizen at least 21 years of age being the primary basis. Students come to study, decide to stay and are followed by their parents.[2]
- Additional immigrants arrive under the EB-5 Immigrant Investor Program. Foreign investors can obtain conditional visas that allow their families to live, work and attend school in the United States. To qualify, the individual must invest a minimum of $1 million in new or recently created businesses or $500,000 in businesses in rural or high unemployment areas. Increasing numbers of EB-5 visas are issued to investors from the Far East, China in particular.[3]
- Foreign direct investment in U.S. businesses is substantial. Measured on a cumulative basis, it reached $2.7 trillion at the end of 2012. In 2012 alone, $166 billion in foreign direct investment flowed into the United States. The United States receives more foreign direct investment than any other country in the world.[4]
- Foreign investment in U.S. real estate, both commercial and residential, represents measurable market share. While London is the number one city for foreign real estate investors, New York, San Francisco, Houston, Los Angeles and Miami are prime locations.[5] Foreign buyers acquired over $68 billion in single family homes in the United States in 2013.[6]

Four Inbound Wealth Scenarios

There are four common scenarios that potentially trigger U.S. income tax or gift, estate or generation-skipping transfer (GST) tax (collectively, the U.S. transfer tax regime) on the inbound wealth of a foreign individual: (1) direct U.S. investment, (2) conducting U.S. business activities, (3) children coming to the United States, or (4) a wealth owner coming to the United States. A foreign person's first foray into the United States may be motivated by a desire to access the relative safety, stability and transparency of the U.S. financial markets and banking system or, possibly, the skilled and productive U.S. workforce. Students come to glean the benefit and prestige of the U.S. higher education system. And, once investments and children are here, the senior generation wealth owners frequently follow.

Opportunities in wealth planning for foreign persons arise from differences between the U.S. income and transfer taxation of U.S persons and foreign persons.[7] We have a preferred income and transfer tax regime for foreign persons, driven by a public policy to foster foreign investment in the United States.

From an income tax perspective, U.S. citizens and residents are taxed on their worldwide income, regardless of source, unless an exception or tax treaty applies. By contrast, foreign persons are only taxed on their U.S. source income. U.S. corporations are taxed on their worldwide income, regardless of source, unless properly structured otherwise. Foreign corporations are taxed on their U.S. income. For transfer tax purposes, U.S. citizens and residents are subject to tax on their worldwide assets, regardless of situs, unless an exception or treaty applies. However, foreign persons are only taxed on transfers of their

Cynthia Brittain, far left, is a senior fiduciary officer at The Northern Trust Company's Santa Barbara, Calif. office, and **Suzanne Shier** is chief wealth planning and tax strategist in The Northern Trust Company's Chicago office

U.S. situs assets, and even that limited scope of taxation is subject to a number of further exclusions.

The potential planning pitfalls arise from the very same differences in the tax rules that present the planning opportunities. Failing to identify these differences and plan accordingly can lead to unanticipated and unnecessary taxation. In addition, there are increasing levels of tax compliance and reporting to be aware of, most recently the Foreign Account Tax Compliance Act. The compliance and reporting requirements can be both complex and unintuitive. The intricacies of tax reporting compliance are beyond the scope of this article but must be taken into consideration in planning for foreign persons and for those with foreign accounts and assets.

Income Tax: U.S. vs. Foreign Person

In most cases, a foreign person is able to avoid being subject to U.S. income tax if he's thoughtfully invested in a U.S. tax-efficient platform intentionally designed to escape U.S. income taxation.

> Gains on the sale of U.S. real property by foreign persons are also subject to withholding and income taxation.

And, while preferred U.S. income taxation on the sale of U.S. real property may not be available under the Foreign Investment in Real Property Tax Act, certain holding structures can help shield against U.S. transfer taxes for future generations.

Absent planning, certain U.S. income will be subject to withholding for U.S. income tax purposes. In general, a payment to a foreign person will be subject to U.S. income tax withholding if it's deemed sourced in the United States and it's either "fixed and determinable annual or periodical" (FDAP) income or gains from the disposition of timber, coal and iron ore or from the sale or exchange of patents, copyrights and similar intangible property.[8] FDAP income includes: (1) compensation for personal services, (2) certain interest payments, (3) dividends, (4) original issue discount, (5) pension and annuity payments, (6) alimony, (7) rents, (8) royalties, (9) taxable scholarships and fellowship grants, (10) prizes, (11) commissions, (12) distributed net income of an estate or trust that has FDAP income and must be distributed currently or has been paid or credited during the tax year, (13) FDAP income distributed by a partnership, and (14) racing purses.[9] Gains on the sale of U.S. real property by foreign persons are also subject to withholding and income taxation.

U.S. income not subject to withholding includes: (1) portfolio interest on bearer obligations or foreign-targeted registered obligations if those obligations meet certain requirements, (2) U.S. bank deposit interest that isn't effectively connected with the conduct of a U.S. trade or business, (3) original issue discount on certain short-term obligations, (4) certain nonbusiness gambling income, (5) amounts paid as part of the purchase price of an obligation sold between interest payment dates, (6) original issue discount paid on the sale of an obligation other than a redemption, and (7) insurance premiums paid on a contract issued by a foreign insurer. Foreign source income of a foreign person isn't subject to U.S. tax withholding or U.S. income taxation.

"Tax Treatment," p. 42, summarizes the U.S. income taxation of the U.S. source income of a foreign person.

Transfer Taxes: U.S. vs. Foreign Person

There are multiple transfer tax planning opportunities for foreign persons, some of which can be highly advantageous. Recall that the determination of whether an individual is a U.S. or foreign person differs for income tax and transfer tax purposes. Thus, an individual may be a U.S. person for federal income tax purposes but a foreign one for U.S. transfer tax purposes. Furthermore, estate and gift taxes apply differently across tangible and intangible asset classes. If the individual is foreign for transfer tax purposes, his U.S. situs tangible and intangible assets will be subject to U.S. estate taxes (and any associated GST tax). By contrast, only his U.S. situs real property and U.S. situs tangible personal property will be subject to U.S. gift tax (and any associated GST tax). U.S. situs intangible personal property isn't subject to gift tax.

The very limited scope of the U.S. gift tax on foreign persons presents significant planning opportunities for foreign persons with a U.S. family. A foreign parent with children and grandchildren in the United States can establish a foreign grantor trust or, in certain circumstances, a U.S. domestic dynasty trust and transfer foreign assets and/or U.S. securities into it. The transfer to the trust will be required to be reported if the value exceeds a minimum amount ($100,000 for transfers from a non-resident alien), but there will be no gift or GST tax on the foreign donor and, if the interests of the beneficiaries are appropriately limited, no subsequent estate or GST tax on the trust on the death of a beneficiary.

There are a number of tax rules specific to foreign persons that can present potential pitfalls. A foreign person is only allowed a limited $13,000 cre it (the equivalent of a $60,000 exclusion, rather than a $5 million indexed applicable exclusion) for estate tax but no similar credit for gift tax.[10] The $13,000 estate tax credit and the corresponding exclusion may be increased by applicable treaty.[11] For gift tax, there's no lifetime credit, only annual Internal Revenue Code Section 2503(b) gift exclusion amounts ($14,000 per donor per donee in 2014). No gift-splitting is permitted unless each spouse is a citizen or resident of the United States at the time of the gift.[12] However, a full $5 million indexed ($5.34 million in 2014) GST tax exemption is available for foreign persons, if subject to U.S. estate or gift tax.

For both U.S. and foreign persons, if the spouse isn't a U.S. citizen, there's no unlimited marital gift or estate tax deduction, and the familiar presumption that only one-half of joint interests between spouses is included in the gross estate doesn't apply.[13] For transfers at death, an unlimited marital deduction is allowed for transfers to a qualified domestic trust,[14] and there's an augmented annual gift tax exclusion for gifts to a non-U.S. citizen spouse ($145,000 in 2014).[15]

Tax Treatment

What a foreigner must pay for U.S. source income

Type of U.S. Source Income	General U.S. Income Tax Treatment
Capital Gains (except real property gains)	Generally, short- and long-term capital gains are excluded from U.S. income tax. If the non-U.S. resident non-U.S citizen (NRA) was in the United States for 183 days or more during the tax year, the net gain from sales or exchanges of capital assets is taxed at 30 percent. Capital gains also are taxed if they're effectively connected with a trade or business in the United States during the tax year.
Dividends	Generally included in NRA withholding tax as U.S. source taxable income subject to 30 percent withholding, subject to tax treaty rates.
Interest From Bank Accounts	Excluded from NRA withholding tax; however, under the Foreign Account Tax Compliance Act (FATCA), bank deposit interest paid by non-U.S. branches of U.S. banks is subject to withholding beginning Jan. 1, 2017.
Interest From Bonds or Other Debt Obligations	Taxable and subject to 30 percent NRA withholding tax, unless the portfolio interest exemption (see below) or an income tax treaty applies.
Portfolio Interest Exemption*	Excludes interest paid to non-U.S. persons on bonds and other debt obligations held for investment from NRA withholding tax if: (1) The obligation identifies the payer (is in registered form); (2) The payee is a foreign individual or entity and is the beneficial owner of the income; and (3) The foreign individual or entity provides a Form W-8 to the payer. See Forms W-8BEN, 1042 and 1042-S. Other portfolio exemptions apply. See Publication 515. *This exemption doesn't apply if the foreign investor owns 10 percent or more of the U.S. corporation or partnership that issued the obligation if the obligation arises in the course of a bank's extension of credit. The exemption also generally doesn't apply to interest tied to the issuer's receipts, sales, cash flow or income. Nor does this exemption apply to registered debt convertible to bearer form. The portfolio interest exemption doesn't apply to withholding under FATCA, which came into effect July 1, 2014.
Capital Gains From the Sale of Real Estate	Under the Foreign Investment in Real Property Tax Act, such capital gains are treated as effectively connected income (ECI), and proceeds are taxed on a net basis. However, 10 percent withholding is required on the gross sale price, unless the seller applies for reduced certification. See Forms 8288 and 8288-A.
Rental Income	Income generated by the use of U.S. real estate is subject to 30 percent NRA withholding tax. However, a special election may be made to treat U.S. real property interests as ECI so tax may be paid on only the net income (income less deductions attributable to rental income). Timely U.S. tax returns must be filed to receive the benefit of this election.
Mutual Funds*	Certain interest-related dividends and short-term capital gains dividends from U.S. issuers were excluded from U.S. income tax, but these exclusions expired for fund years beginning after Dec. 31, 2013. The exclusions could be extended by Congress at a future date. Long-term capital gains distributions are excluded from U.S. income tax. * The mutual fund will designate in writing which dividends are interest-related dividends or short-term capital gains dividends

—The Northern Trust Company

"Comparing the Transfer Taxes," p. 44, summarizes the U.S. transfer taxation of foreign persons compared to U.S. persons.

A Second Look

By helping your client plan in anticipation of investment or arrival in the United States, you may be able to optimize his tax benefits more readily. And, a second look after your client becomes a U.S. person for income tax purposes, but before he becomes a U.S. person for transfer tax purposes, can be highly beneficial. Here are some steps your client should consider taking.

- **Evaluate entities, including partnerships, limited liability companies, corporations and trusts.** The U.S. income and transfer tax treatments of foreign and U.S. entities frequently differ significantly. Determine how a pending U.S. investment or move will impact entity tax treatment. If disadvantageous, consider taking corrective action before the investment or move is made. Foreign trusts and holding companies should be reviewed carefully, due to the tax burden that may be imposed on distributions to U.S. persons.
- **Create entities.** If a foreign person intends to acquire U.S. real estate, direct purchase is likely the least tax-efficient approach. Rather, with proper planning, acquisition through a foreign corporation can transform ownership of U.S. real property (subject to U.S. gift and estate taxation) to ownership of a foreign corporation (not subject to U.S. gift or estate taxation).
- **Establish trusts for gift and estate planning.** Trusts can be extremely beneficial for pre-immigration planning. Making a completed gift of foreign assets into a dynasty trust before establishing a U.S. domicile can effectively remove the gifted assets from U.S. transfer taxes, not only for the foreign person coming to the United States, but also for the trust beneficiaries for generations to come.
- **Make gifts.** If a foreign person intends to establish a U.S. domicile, consider making gifts, including gifts to a spouse, before coming to the United States. Gifts of foreign assets prior to establishing a U.S. domicile won't be subject to gift or GST tax. This is of particular significance when a spouse isn't and won't become a U.S. citizen, as there's no unlimited marital gift tax deduction for gifts to a non-U.S. citizen spouse, only the enhanced annual gift tax exclusion discussed above.
- **Accelerate income and defer expenses.** Depending on the tax regime of the home country, it may be advantageous to recognize gain on appreciated assets and accelerate other types of income before coming to the United States. Delaying payment of expenses that generate income tax deductions until the individual becomes a U.S. person may also be beneficial.

Comparing the Transfer Taxes

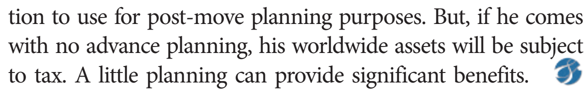
Foreign person versus U.S. person

Category	Non-U.S. Domicile/Resident and Non-U.S. Citizen	U.S. Domicile/Resident or U.S. Citizen
Estate Tax	Taxed on U.S. situs assets (real, tangible personal and intangible personal)	Taxed on worldwide assets
Applicable Exclusion Amount	$60,000, subject to treaty modified pro rata rules, only available for estate tax purposes, not available for lifetime gifts	$5.34 million in 2014, available for estate, gift and generation-skipping transfer tax purposes
Gift Tax	Taxed on gratuitous transfers of U.S. situs assets (real, tangible personal)	Taxed on all gratuitous transfers
Annual Gift Tax Exclusion	• $14,000 in 2014 • Gift splitting with spouse not allowed unless both are either U.S. domicile/resident or U.S. citizen	• $14,000 in 2014 • Gift splitting with U.S. domicile/resident or U.S. citizen spouse allowed
Transfers to a Non-U.S. Citizen Spouse	• No unlimited marital deduction for transfers to non-U.S. citizen spouse • Lifetime gifts to non-U.S. citizen spouse, annual gift tax exclusion $145,000 in 2014 • Estate tax marital deduction for transfers to a qualified domestic trust • Contribution rule for joint tenancy with non-U.S. citizen spouse; deferred gift treatment of joint tenancy in real property	

—The Northern Trust Company

Advance Planning is Key

Consider a foreign person holding cash in a U.S. bank account, stock in a foreign holding company invested in U.S. markets and U.S. real estate held in a foreign corporation. No matter the value of the assets, he ordinarily won't be subject to U.S. estate tax at death under current law. And, if the foreign person intends to come to the United States and establish domicile here, but makes substantial gifts in advance, he will incur no U.S. gift tax on the pre-move gifts. Once he becomes a U.S. person, he will have the full $5 million, indexed, applicable exclusion amount and GST tax exemp-



tion to use for post-move planning purposes. But, if he comes with no advance planning, his worldwide assets will be subject to tax. A little planning can provide significant benefits.

Endnotes

1. "Open Doors 2013—Report on International Educational Exchange," Institute of International Education, in partnership with the Bureau of Educational and Cultural Affairs, U.S. Dep't of State, *www.iie.org/Research-and-Publications/Open-Doors.*
2. "Report of the Visa Office 2013," U.S. Dep't of State—Bureau of Consular Affairs,*http://travel.state.gov/content/visas/english/law-and-policy/statistics/annual-reports/report-of-the-visa-office-2013.html.*
3. "Immigrant Investor Visas," U.S. Dep't of State—Bureau of Consular Affairs, *http://travel.state.gov/content/visas/english/immigrate/types/Immigrant-Investor-Visas.html.*
4. "Foreign Direct Investment in the United States 2013 Report," Organization for International Investment, *www.ofii.org/sites/default/files/FDIUS_2013_Report.pdf.*
5. "Ranking of Global Cities for Real Estate Investment," Association of Foreign Investors in Real Estate, *www.afire.org/sites/default/files/pdf/survey-2014-ranking-of-global-cities-for-real-estate-investment.pdf.*
6. "2013 Profile of International Home Buying Activity: Purchases of U.S. Real Estate by International Clients for the Twelve Month Period Ending March 2013," National Association of Realtors, *www.realtor.org/sites/default/files/2013-profile-of-international-home-buying-activity-2013-06.pdf.*
7. The determination of whether a person is U.S. or foreign for U.S. income taxation differs from the determination for U.S. transfer taxes. We use the term "foreign person" to refer to a person who isn't a U.S. citizen and isn't a "resident" for income tax purposes (commonly referred to as a non-resident alien or NRA) or not "domiciled" or "resident" for gift, estate and generation-skipping transfer tax purposes (a non-domicile/resident non-citizen). When dealing with a specific individual situation, it's important to make a determination of residence and domicile.
8. Internal Revenue Code Sections 871(a) and 881(a).
9. Fixed or determinable annual or periodical income or effectively connected income (ECI) may not necessarily be subject to U.S. graduated rates with allowable deductions. Country-specific treaty rules and tax elections may apply. For example, a foreign person may wish to elect to have rents treated as ECI to apply associated deductions.
10. IRC Section 2102(b).
11. Section 2102(b)(3).
12. IRC Section 2513(a)(1).
13. IRC Sections 2056(d)(1) and 2523(i).
14. Section 2056A.
15. Section 2523(i)(2).

United States Postal Service Statement of Ownership, Management, and Circulation (Requester Publications Only)

1. Publication Title: Trust & Estates
2. Publication Number: 495-930
3. Filing Date: 9-30-2014
4. Issue of Frequency: Monthly
5. Number of Issues Published Annually: 12
6. Annual Subscription Price: $375
7. Complete Mailing Address of Known Office of Publication (Not Printer): Penton, Media, Inc., 9800 Metcalf Ave., Overland Park, Johnson County, KS 66212-2216 Contact Person: Nathan Clark Telephone: 212-204-4263
8. Complete Mailing Address of Headquarters or General Business Office of Publisher (Not Printer): Penton Media, Inc. ,1166 Avenue of Americas 10th Floor New York, NY 10036
9. Full Names and Complete Mailing Addresses of Publisher, Editor, and Managing Editor - Publisher: Rich Santos, 1166 Avenue of the Americas 10th Floor, New York, NY 10036; Editor: Susan Lipp, 1166 Avenue of the Americas 10th Floor, New York, NY 10036.
10. Owner - Full name and complete mailing address: Penton Media, Inc., 1166 Avenue of the Americas, New York, NY 10036; Penton Business Media Holdings, Inc. (owns 100% of the stock of Penton Media, Inc.), 1166 Avenue of the Americas, New York, NY 10036
11. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages or Other Securities: None
12. "Tax Status (For completion by nonprofit organizations authorized to mail at nonprofit rates) (Check one) The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes: N/A"

	"Average No. Copies Each Issue During Preceding 12 Months"	No. Copies of Single Issue Published Nearest to Filing Date	
13. Publication Title: Trust & Estates			
14. Issue Date for Circulation Data: November 2014			
15. Extent and Nature of Circulation			
a. Total Number of Copies (Net press run)			b.
Legitimate Paid and/or Requested Distribution (By Mail and Outside the Mail)	9,409	9,073	
(1) Outside County Paid/Requested Mail Subscriptions stated on PS Form 3541. (Include direct written request from recipient, telemarketing and Internet requests from recipient, paid subscriptions including nominal rate subscriptions, employer requests, advertiser's proof copies, and exchange copies.)	8,134	7,807	
(2) In-County Paid/Requested Mail Subscriptions stated on PS Form 3541. (Include direct written request from recipient, telemarketing and Internet requests from recipient, paid subscriptions including nominal rate subscriptions, employer requests, advertiser's proof copies, and exchange copies.)	0	0	
(3) Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Paid or Requested Distribution Outside USPS®	25	28	
(4) Requested Copies Distributed by Other Mail Classes Through the USPS (e.g. First-Class Mail®)	0	0	
c. Total Paid and/or Requested Distribution (Sum of 15b (1), (2), (3), and (4))	8,159	7,835	
d. Nonrequested Distribution (By Mail and Outside the Mail)			
(1) Outside County Nonrequested Copies Stated on PS Form 3541 (include Sample copies, Requests Over 3 years old, Requests induced by a Premium, Bulk Sales and Requests including Association Requests, Names obtained from Business Directories, Lists, and other sources)	132	139	
(2) In-County Nonrequested Copies Stated on PS Form 3541 (include Sample copies, Requests Over 3 years old, Requests induced by a Premium, Bulk Sales and Requests including Association Requests, Names obtained from Business Directories, Lists, and other sources)	0	0	
(3) Nonrequested Copies Distributed Through the USPS by Other Classes of Mail (e.g. First-Class Mail, Nonrequestor Copies mailed in excess of 10% Limit mailed at Standard Mail® or Package Services Rates)	0	0	
(4) Nonrequested Copies Distributed Outside the Mail (Include Pickup Stands, Trade Shows, Showrooms and Other Sources)	495	655	
e. Total Nonrequested Distribution (Sum of 15d (1), (2), (3), and (4))	626	794	
f. Total Distribution (Sum of 15c and 15e)	8,785	8,629	
g. Copies not Distributed	624	444	
h. Total (Sum of 15f and g)	9,409	9,073	
i. Percent Paid and/or Requested Circulation (15c divided by 15f times 100)	92.87%	90.80%	
16 Electronic Copy Circulation			
a. Requested and Paid Electronic Copies	-	-	
b. Total Requested and Paid Print Copies (Line 15c)+ Requested/Paid Electronic Copies (Line 16a)	8,159	7,835	
c. Total Requested Copy Distribution Distribution(Line 15f) + Requested/Paid Electronic Copies	8,785	8,629	(Line 16a)
d. Percent Paid an/dor Requested Circulaltion (Both Print & Electronic Copies)	92.87%	90.80%	(16b diveded by 16c x 100)

I certify that 50% of all my distribution copies (electronic and print) are legitimate requests or paid copies:

17. Publication of Statement of Ownership for a Requester Publication is required and will be printed in the: Nov-14 issue of this publication. Date 9/30/14
18. Nathan Clark: I certify that all information furnished on this form is true and complete. I understand that anyone who furnishes false or misleading information on this form or who omits material or information requested on the form may be subject to criminal sanctions (including fines and imprisonment) and/or civil sanctions (including civil penalties).

Posted with permission from November 2014. Trusts & Estates, Penton Media, Inc. Copyright 2014. All rights reserved.
For more information on the use of this content, contact Wright's Media at 877-652-5295

112528